MANUFACTURERS HANOVER

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# Economic Report

December 1991

Commentary on Pertinent Economic Issues

## Impatience Is Not A Virtue

**Irwin L. Kellner**
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It seems as though one cannot pick up a newspaper nowadays without reading about one company or another announcing sizable staff layoffs. These cutbacks many times have followed the release of a disappointing earnings report and/or forecast. To save even more money, some companies have begun to discharge relatively senior people. These older employees, of course, tend to be paid more, so their firing saves more dollars than the termination of an equal number of younger, lower-paid workers. The fact that these companies are parting with experienced, highly-skilled workers, whose loss might be keenly felt in the future is, of course, rarely mentioned.

It is not hard to discern the strategy behind these moves. In a world in which being publicly held means managing for the next quarter's earnings report, companies appear to be placing increasing emphasis on impressing investors with swift actions being taken to cut costs and boost profits in order to bolster the price of their stock. There is some irony to this, however, since in many cases the Wall Streeters these firms are trying to curry favor with are none other than the managers of the pension funds for the very same employees who are losing their jobs!

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### Short-Run Obsession

To be sure, one can sympathize with American business's seeming obsession with short-run performance. This is because, with few exceptions, those U.S. companies whose shares are in the hands of the public report their sales and earnings results every three months. These periodic reports are essential, if shareholders—usually absentee owners with little, if any, involvement in running the firm—are to have timely information regarding the state of their investment.

If these investors are satisfied, they will hold onto their stock in the company—if not purchase some more. Needless to say, this will bolster the price of the stock, making not just investors, but the company's managers, themselves, pleased. Since part of many managers' compensation depends on the performance of their company's stock, they obviously have a vested interest in seeing its price rise. Indeed, this is one of the first lessons taught in business schools—to maximize shareholder return, then take care of sueh other corporate constituencies as employees, customers, suppliers and the general public.

As you can imagine, this has produced a system that tends to be geared toward short-term thinking. More than one corporate consultant has observed that executives will not concentrate on the long term until incentives are strong enough to counteract the stimulant of the near term, which, of course, is quarterly profits. In and of itself, this is not all that bad. However, in more than a few instances it results in managers taking action to bolster their companies' stock price in the short term at the expense of sacrificing good long-term returns. To put it another way, for those companies whose shares are listed (and even for many who are privately-held, since, in some cases, they compete with their publicly-held brethren), few actions are undertaken that have no obvious short-run payoff.

### Politics Plays A Role

Sometimes efforts to plan for the longer term are impeded by governments at the Federal, state and local level. Congress, for example, tends to enact legislation that changes the rules of the game—rules on which corporate, as well as individual investor decisions were based. The most glaring instance is the investment tax credit, which has been in and out of the tax code a number of times since it was first instituted back in 1962. Even more significant is the Tax Reform Act of 1986, which suddenly and dramatically changed the rules for investing, especially in real estate. Many people think it was the forerunner of the latest national recession.

Elected officials, of course, face even more severe pressures to act for the short term than business people. They must appease their constituents by spending more and/or by cutting taxes before their term of office expires. Since the entire House of Representatives and one-third of the Senate come before the voters ev-

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ery two years, you can see why they need favorable results quickly—even if the economy might suffer in the longer run. Indeed, to a politician, the long run is the day after Election Day!

To be sure, most companies do have people on their staffs engaged in long-range planning. Not surprisingly, most senior managers, if asked, will tell you that they operate under a long-range plan. As a matter of fact, in some industries, long-range planning is essential if they are to grow and prosper. Pharmaceuticals and aerospace, where lead times of ten years or more are necessary before a new product begins to produce a profit, are just two examples.

One can certainly understand the need for long-range planning. To increase productivity and competitiveness, massive investments in research and development, plants and equipment, training and education of the workforce are absolutely essential. While governments invest in infrastructure, companies must invest in new methods of production, distribution and communication. Clearly, these require time before their benefits become apparent.

Unfortunately, we have become too impatient. More than one observer of the American business scene has recalled the statement usually attributed to the great economist, John Maynard Keynes, that "in the long run we're all dead," and urged concentration, instead, on short-run objectives. All well and good, but when the short run becomes as short as the next calendar quarter, and the objective is simply maximizing short-run profits, many companies tend to lose their way. They lose sight of who they are, and where they are going. Writing in the *Harvard Business Review* not long ago, a professor of management at Harvard's Business School said: "Most companies select goals that are too short term... (a) series of short-term goals encourage episodic thinking... (they) also work to back companies into a mode of thinking that is based on forecasts (What do we think is going to happen?), rather than on vision (What do we want to happen?)."

### Layoffs Threaten Recovery

This brings us to the U.S. economy's current dilemma. Just when the economy seemed to be emerging from its ninth postwar recession, in the spring of 1991, company after company suddenly became impatient, and began laying off workers. Never mind that virtually all economists were expecting only a mild recovery. As was observed in the June issue of this Report: "...to many, it will be difficult to distinguish between recession and recovery... (t)he muted nature of this recovery contrasts with past rebounds... (r)egardless of when they believe this recovery will get underway, practically all forecasters agree that it will be much slower than average." And the April Economic Report gave the reason for these modest expectations. It pointed out that many of the factors which gave rise to this latest recession are still around.

This impatience now threatens the nascent recovery. For these layoffs have now become widespread, and, in turn, have depressed confidence. To be sure, this is not the first time people have lost their jobs en masse. What is different today, however, is, first, that it is occurring during a period of rising economic activity, and, second, that it is taking place mainly in the service sector of the labor force. The spreading loss of confidence that has developed in the wake of these layoffs in particular stems from the fact that four-fifths of American employees work in the service sector. In other words—almost everybody knows somebody who has lost a job and/or is unable to work in the field for which he or she is qualified.

### Vicious Cycle

These layoffs have produced a vicious cycle. As people have lost (or know others who have lost) their jobs, they bcome depressed. Naturally, they curtail their spending, buying only what they must, opting for the least expensive brand in the least expensive outlet. At the same time, they are eschewing such big-ticket, postponable items as cars, houses and household furnishings. Naturally, this produces disappointing sales and earnings—leading to yet another round of layoffs, and so on.

Welcome to the corporate version of musical chairs. Not only are companies looking mainly at short-term results, they are trying to improve their fortunes at the expense of others, who, of course, are returning the favor. Since no one can order this process to halt, what can be done to stop this, before it aborts the fledgling recovery, and pushes the U.S. economy down into another, even deeper, recession?

Don't look to monetary policy to be of much assistance. The Federal Reserve has cut short-

term interest rates in half over the past two years and not only has this failed to prevent a recession—it hasn't led to the rise in borrowing necessary to produce a vigorous upturn. In today's low-confidence environment, the Fed could push interest rates down to zero; if people are afraid of losing their jobs, they are not going to borrow to buy the big-ticket items that drive the economy. For its part, business won't borrow, either, if it sees only dim prospects for sales. Those who do try to borrow are many times unable to do so, as the banks, hobbled by loan losses, unusually strict examination and capital standards, ration their loans.

This could be the 1990s version of the 1930s "liquidity trap," a theory that was also advanced by Keynes, as justification for the need for fiscal stimulus in times like these. As Keynes pointed out, you can pull on a string, but you cannot push on it. In other words—tight money can cool off an overheated economy, but easier money alone may not necessarily do the job of reviving it.

### Time For Fiscal Stimulus

It seems fairly obvious that we need fiscal stimulus. Specifically, the government must assume the role of employer of last resort. We have a crying need to increase public investment in roads, bridges, water and sewer systems. Our crumbling infrastructure demands no less. More than one observer of the business scene has pointed out how such a policy could simultaneously address the twin problems of lack of confidence and depressed spending. Anytime an unemployed person finds a job, that person naturally feels better. And every dollar that person earns in his or her new job will be spent and then some, as deferred needs are addressed.

It does not take a rocket scientist to see how such a program could have tremendous ripple effects—enough to jump-start the economy and put the recovery into second gear. For although this would begin as a public program, most of the money spent would flow through the private sector, since Washington does not make steel, cement or wire cables. Thus many businesses would get an immediate lift, in the form of an increase in orders. They, in turn, would have to hire people to fill these orders, who would have more to spend, and so forth. While we are at it, let's be sure to extend the period of time the unemployed can receive jobless benefits; this will boost these people's confidence, too.

But spending is only one blade of the fiscal shears. Tax cuts are necessary as well, in order to inject purchasing power into the hands of the vast majority of people who would not be immediately helped by this program of infrastructure spending. First of all, cut those Social Security taxes—the biggest tax the average household pays. Restore the deductibility of interest and taxes for individuals and you might encourage additional borrowing and spending.

Repeal the luxury tax. This has turned out to be more harmful to those who build the fancy cars, private planes and yachts than to would-be buyers. Help business overcome its lack of confidence by making it cheaper to invest in people, equipment, and even physical plant. Cut the capital gains tax and restore the investment tax credit. These were the key provisions of the 1986 Tax Act, which, as noted above, hurt the real estate market, so why not go all the way and repeal this Act, thus enhancing the value of many properties?

Help real estate and you help the banks, but to make sure, the bank examiners must be ordered to treat real estate loans more reasonably. Whether they realize it or not, real estate cannot be valued on a daily basis the way stocks and bonds are. And while no banker would argue against the need for more capital, the current requirements should be delayed, in order to enable the banks to lend more to those who need it. The banks should also be allowed to diversify their products and to expand across state lines; this would add to their health, which is plainly necessary for a healthy economy.

Would these fiscal actions undertaken by Washington widen its already-swollen budget deficit? Probably, unless some offsets are found in the shrinking defense budget, or in the entitlement programs. However, this should not be too worrisome at this time. For one thing, the deficit is so large, a few billion dollars more shouldn't make much of a difference to the financial markets. For another, as President Herbert Hoover learned, you shouldn't try to balance the Government's budget when the economy is weak; it only makes things worse—including the deficit. The time to have reduced the budget deficit by spending restraint and/or by tax hikes is past; it will come again once the economy strengthens.

Meanwhile fiscal stimulus is just about all we've got left to jump-start the economy. Let's do it now—and avoid more misery later.

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*Economic Report*

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MANUFACTURERS HANOVER

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February 1992

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## The Only Thing We Have To Fear...

The gloom enveloping the United States economy these days is so thick you could cut it with a knife. Survey after survey shows confidence declining—and with it, the President's standing among the electorate. Most people are afraid of losing their jobs; many know someone who either has become unemployed, or is unable to work in the field for which he or she is qualified. Then there are the dropouts from the workforce; blue collar workers are known as "discouraged" workers, while white collar workers have become "consultants."

Intensifying these fears were the layoff announcements late last year by several major companies. Not only did these make the front pages of the daily papers and the top of the evening news stories on radio and television, they got many people whose jobs might otherwise be secure to figure that "if these blue-chip firms are letting people go, what hope is there for the rest of us—including me?" And by playing up these negative stories, while downplaying such positive stories as new plant openings and hirings, the press probably contributed to this malaise as well.

Little wonder that the 1991 Holiday shopping season was disappointing. Not only did sales in November and December decline, seasonally adjusted, but merchants' results for the full year were the worst since the Government began keeping records 25 years ago. In their negative frame of mind, consumers confined their spending to those items they had to buy; they searched for the least expensive version from the lowest-priced outlet. Needless to say, this cast a pall on retailers' willingness and ability to order merchandise for the next selling season, which, of course, has depressed activity among suppliers.

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### The Numbers Aren't That Bad

Are things really as bad as people think? Or will it turn out that the only thing we have to fear is fear itself? To put it another way, there are far more positive statistics than there are negative numbers—but if the public's mood doesn't brighten soon, we could well talk ourselves into something far worse than we've actually experienced.

After examining the data carefully, even the gloomiest analyst would have to admit that—whatever you call this period, it certainly does not contain the characteristics of a severe slump, much less the "free fall" described by the President in a recent campaign swing through New Hampshire. Indeed, regardless of when the recession "officially" ended, the year 1991 contained many bright spots:

- New-home construction and sales jumped more than 26 percent;
- New orders for durable goods have risen ten percent since March—with nondefense capital goods bookings soaring more than 25 percent since May;
- Total business shipments increased for eight consecutive months—the first time this has happened since 1983, when the economy was emerging from the last recession;
- Inflation-adjusted exports have gone up by 12½ percent since February, helping manufacturing production to rise one percent last year, after falling by about that much during the previous year;
- Business inventories are back in line with sales, with a ratio of 1.50, while in the key and cyclical manufacturing sector, the inventory-sales ratio, at 1.53, is now at a 12½-year low;
- Consumers are saving over five percent of their take-home pay—more than they did during the years 1987-91;
- Use of debt has declined over the past year, bringing the ratio of consumer installment debt outstanding to disposable personal incomes down to 17 percent—about the lowest in six years;
- Buying power is beginning to grow, since inflation at the producer level disappeared last year, and ran at a five-year low of only three percent at the consumer level;
- The unemployment rate averaged 6.7 percent in 1991—lower than in every month from April 1980 through November 1986 except for January 1986, when it was also 6.7 percent;
- Employment actually rose by 237,000 in the

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last three months of 1991, but since it normally goes up by about 464,000 during this period, it was reported as a decline of 227,000, after seasonal adjustment.

Most of these statistics, along with several others, are incorporated in the gross domestic product, the all-encompassing measure of what is produced within our borders. Government calculations show that the GDP rose in the second, third and fourth quarters of last year; this is why many believe that the recession, which "officially" began in August 1990, probably came to an end in April or May of 1991. For never before in the postwar era has a recession been interrupted by three back-to-back growth quarters.

To these favorable developments should be added:

*The 25 percent jump in stock prices over the past year.* This kind of an increase helps the economy in three ways: (1) by adding to general confidence levels; (2) by making shareholders wealthier, thus able to spend more; (3) by enabling publicly-held companies to raise more money for a given dilution of equity.

*The 21 percent drop in oil prices since October.* Since everyone uses oil in some form—whether for gasoline, to transport goods, heating, producing electric power or as a feedstock for plastics and clothing—this kind of a drop will leave people and business with more money for either paying down debt, boosting savings or spending.

*The halving of interest rates over the past 12 months.* This obviously hurts savers, especially retired people, but it does enable borrowers—usually younger people and businessmen—to pay less, either through an interest rate that floats downward, or through refinancing an existing fixed-rated loan.

By now, it should be clear to the reader that everything is in place for an improvement in the pace of business activity this year. All that's needed is for the consumer to regain confidence. But herein lies the problem—you cannot order people to be more confident when they fear for their jobs any more than you can order business *not* to manage for the bottom line, which means cutting staff when cost reductions become necessary.

### People Have Lots of Worries

One of the reasons why people got so depressed late last year was a feeling that Washington either didn't recognize that the economy needed help and/or didn't have a plan to rectify it. The last issue of this Report offered a number of suggestions, some of which were incorporated in the President's State of the Union address. The very fact that the President has turned his attention back to domestic affairs should help boost confidence in and of itself.

But it will take more than words to shake people out of their lethargy. For they are also depressed by such other factors as the decline in the value of their biggest asset, their home, still-high debt loads, soaring health care costs, difficulty in maintaining living standards since many state and local taxes, tolls and transit fares keep going up, lack of jobs for young people just out of school, and our decaying physical and social infrastructure.

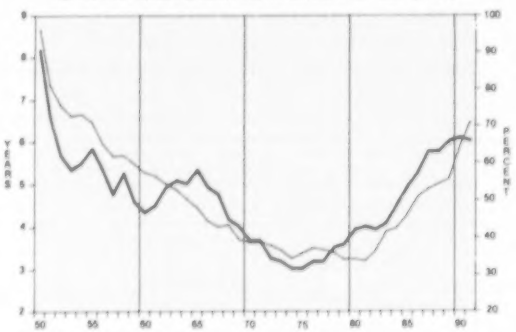
To these must be added a few personal fears. Take monetary policy, for example. When the Federal Reserve departed from its previous policy of small cuts in interest rates and slashed its discount rate by a full percentage point on December 20, it was even more significant than it looked. True, it was the largest point drop for this key rate in ten years. However, in 1981 rates were almost three times higher; 1991's one-point decline from 4½ percent to 3½ percent represented the fourth largest *relative* cut in history. The other three all took place during the Great Depression!

To drive rates down this fast required a sizable injection of reserves into the banking system, for the Fed had to supply more funds than the banks needed in order to push down their price. As a consequence, bank reserves are now growing at a yearly clip of over nine percent—the fastest rate of increase in more than four years . And while this has yet to translate into rapid money growth (M2 last year barely hit the Fed's minimum target of a 2½ percent increase), this is only because the low level of interest rates has caused people to withdraw funds from the banking system as their certificates of deposit mature, looking for higher yields elsewhere. M2 excluding these small CDs grew a whopping 8¾ percent last year—almost twice the 4½ percent it logged in during 1990.

In other words, there's a lot of liquidity that's beginning to slosh around in the financial system—even if it has yet to show up in the nation's money supply. When it does, it could rekindle the fires of inflation, which right now are banked.

Latent fears of inflation are one reason why long-term interest rates have not declined as much as those on shorter-dated instruments. The bond markets are always concerned about inflation and what it might do to the value of a long-term investment. This has resulted in an unusually wide gap between short- and long-term interest rates, known in the jargon as a steeply sloped yield curve. To "twist" this curve so that long rates come down, the Treasury has hinted that it might restrict sales of its longer-dated bonds, thereby creating somewhat of a scarcity, which, in turn, would drive down their yields by pushing up their prices.

AVERAGE MATURITY OF FEDERAL GOVERNMENT DEBT (THICK) VS. TOTAL FEDERAL DEBT AS A PERCENT OF GDP (THIN)




Source: Treasury Department

This may not work. As the chart indicates, the Government's debt is now so large relative to the economy that concentrating on selling shorter-dated issues may result in significantly higher interest rates on Treasury bills and notes. Trade is another concern of mine. The President's recent trip to Asia spotlighted our trade deficit—especially with Japan and the newly-industrialized countries (NICs) of the Pacific Basin. In this regard, several points should be noted. First, our trade deficit with Japan has declined by 25 percent since the end of 1987, but has remained the same against the NICs, while rising 17 percent with the Organization of Petroleum Exporting Countries.

The second point has to do with our trade deficit and the state of our economy. Our overall trade gap was much larger in the mid-1980s than it is today—yet the GDP was growing much faster then. From another angle, exports fell from mid-1985 through the first few months of 1986 while the GDP was climbing; today, exports are growing at the fastest rate in two years, yet GDP's growth is down.

I am also concerned that some people don't quite realize the main purpose of trade between two countries. It is not, as has been suggested, that if we buy one country's products, that country should reciprocate by purchasing the same ones from us. There is not much point in doing this. In reality, as economists have maintained for nearly two hundred years, the purpose of international trade is that it be mutually beneficial. In other words, countries should import what they don't have, or aren't good at making, and export what they do have, or are good at making. In the literature this is known as the "doctrine of comparative advantage."

For example, if a country is better at making consumer electronics than airplanes, it should concentrate on making consumer electronics, exporting enough of them to pay for imports of planes. This would apply even if it happened to be the world's best producer of planes; as long as it can make consumer electronic goods better than it can manufacture planes, it will come out ahead by specializing in what it is comparatively good at, and importing the other. This allows countries to trade even if they are not the absolute best at anything.

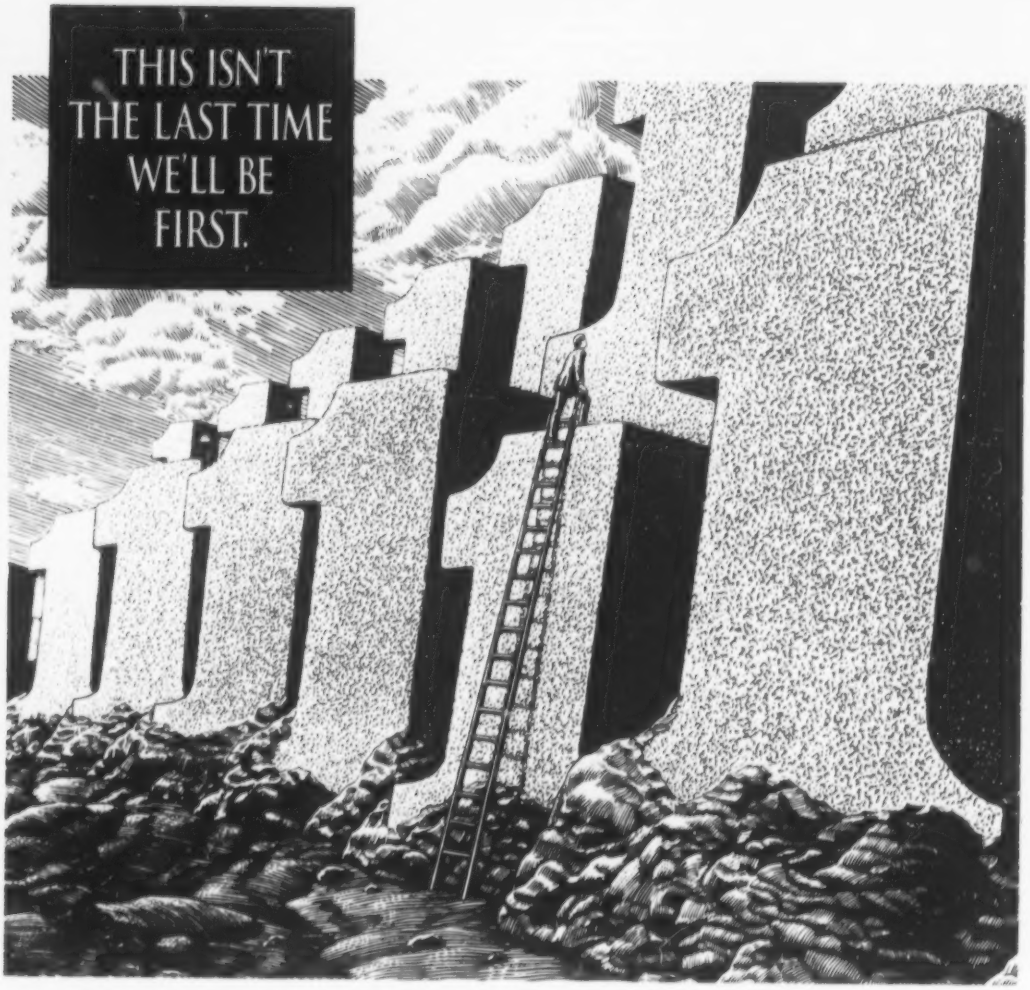
Failure to keep in mind these fundamental principles of world trade led to the passage of the Smoot-Hawley Tariff Act in June 1930. Along with fiscal and monetary policy mistakes, this is widely blamed for turning the recession of 1930 into the Depression of the 1930s.

### Cheer Up—Things Will Improve!

With the hope, then, that business, consumers and government will do the right thing, Chemical Banking's economic forecast for 1992 expects growth to pick up in the current quarter, then gradually speed up in the spring and summer, ending up the year at a respectable (but not spectacular) clip of close to three percent. Business, it is hoped, will soon conclude that its payrolls have been thinned enough, and that, if anything, some additions might soon be needed. Consumers, in turn, will believe that the worst of these layoffs is past, and that their jobs are secure enough to allow them to satisfy some of their pent-up demands by returning to the nation's stores.

Most important, elected officials will display leadership in crafting an economic program that at once brightens people's attitudes, yet does not either overstimulate the economy, nor try to improve our lot by shutting out other countries' goods.

Hope springs eternal. ■

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MANUFACTURERS HANOVER

# Economic Report

April 1992

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**Irwin L. Kellner**
**Chief Economist**

## Random Thoughts

If you're like me, you tend to get caught up in the day-to-day flow of events, many times losing sight of the bigger picture. Too often, these days, we economists spend most of our time waiting for the latest statistic, and/or news item, then rush to come up with an "instant analysis" that fits into a 10-second sound bite on the air, or a pithy quote for the daily newspapers. Many are so immersed in the daily ebb and flow of the data that they literally are unable to see the forest for the trees.

Never has minute-by-minute minutia been more closely scrutinized than today. Economists, businessmen, consumers—and, of course, elected officials—have begun a recovery watch, unsure of whether the economy has emerged from recession or not, and if so, how fast it is likely to add to profits and jobs. And, speaking of elected officials, since 1992 is a year divisible by four, politicians from both major parties are not only examining the data—they are pontificating with increasing intensity, hoping to come up with the program that gets them elected this November.

Everyone needs a break once in a while, so in the interest of helping all of us retain our sanity, I am offering this month, not another update of where we are and where we are going, but some thoughts on several issues that have tended to be overlooked by press and pundits alike.

Economics Department 17/270

### Where's The Umpire?

As many of you know, the official arbiter of the business cycle is an organization called the National Bureau of Economic Research. Like an umpire in a baseball game, the NBER stands between two sides, in this case, between economists in the private sector and those in Washington. Also like an umpire, its decisions are respected by both sides and are final. However, unlike what happens in a baseball game, the NBER doesn't render its decision immediately; it usually waits until enough data are in, and this can take many months.

Case in point: The NBER waited until April 1991 before deciding that America's ninth postwar recession got underway in August 1990. Interestingly, April 1991 may well have been the month when that recession ended. For you see, the gross domestic product, the all-encompassing measure of economic activity within the United States, stopped declining at that time, and has been rising ever since. The GDP, adjusted for inflation, grew at an annual rate of 1.4 percent in 1991's second quarter, 1.8 percent in the third, and 0.4 percent in the fourth.

Now the NBER will be the first to tell you that dating a business cycle's beginning and end involves more than just looking at the gross domestic product, and I agree. However, unless the umpire has changed his definition of what constitutes a recession, then the time has come for the NBER to declare that the recession that began in summer 1990, ended sometime in early 1991. For never in the past has a recession included two consecutive rising quarters of GDP, much less the three already recorded.

Such a declaration would be of no small significance. One of the biggest hurdles confronting the nascent recovery is a distinct lack of confidence on the part of both businessmen and consumers. This is keeping both from spending more, which, of course, is what's needed, if the recovery is to develop momentum and spread throughout the economy. It is not enough for the President, or any other politician with a vested interest in boosting confidence, to say that the recession has ended; people simply wouldn't believe them anymore than they believed Herbert Hoover when he said "prosperity is right around the corner." However, such a declaration from the non-partisan NBER might be enough to boost morale—and outlays.

### Losing Confidence

Not long ago, the Conference Board's respected survey of consumer confidence—presumably a harbinger of future spending—touched its lowest point in over 17 years. Some of the more pessimistic pundits seized upon this reading as a sign that the recession not only didn't end last year, but that it would continue for many months to come. While there no doubt are good reasons for people to feel depressed—especially those who have either lost their jobs or are running harder just to keep up with the rising cost of living—it is inconceivable to me that Americans in the aggregate are so blue.

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Let me remind you what was going on 17 years ago, in December 1974, when confidence was last as low as the Board's February 1992 reading. For one thing, the country was reverberating from the resignation of a President three months earlier—something that had never happened before in our history. Then there was the "oil shock"; soaring prices for oil and gasoline; lines at the pumps; double-digit inflation and interest rates; a credit crunch; falling stock prices; and the "cold war" with the Soviet Union.

Let's look at the situation that existed this past February. The "cold war" was over; the Soviet Union dissolved; oil and gasoline prices had fallen over 25 percent since October 1990; interest rates at quarter-century lows; and a soaring stock market. Hardly reason for people's moods to be so blue, it seems to me. On the other hand, people are concerned that the value of their homes—their biggest asset—has fallen, that many of the jobs that are being lost these days are gone forever, not to return when the economy strengthens, and that elected officials do not appear to have either a realistic plan and/or the ability to address these concerns.

### Why Do We Have Business Cycles?

Readers no doubt know that this past recession has had numerous predecessors. The NBER counts eight since the end of World War II, and a total of 30 since 1854 for the United States. Undoubtedly, there have been others, if the experience of England is any guide. Because data here go back further—even before the U.K. became an industrialized country—it is possible to surmise that business cycles are quite a long-standing feature of almost any society.

The next question is why do these cycles occur? It appears to me as though they can basically be traced to human nature. In the pre-industrial days, when agriculture was the main industry, the occasional bouts of poor growing weather would affect crop production, causing scarcities. In turn, farmers would find that supplies fell short of demand. Someone got the notion that if he could sell all his crops and then some at the prevailing price, why not ask for more, as long as demand exceeded supplies? From this was born inflation, which would proceed until enough people were priced out of the market to necessitate a lowering of prices. Naturally, this involved pain.

As countries became industrialized, and people went to work for others, this attitude went with them. When demand for workers exceeded the supply, labor would tend to ask for more. This pinched business earnings unless matched by a hike in selling prices. Once again, inflation proceeded until buyers were priced out of the market. Business sales would fall, workers would lose their jobs, and prices would decline until market equilibrium was restored.

In modern times, as governments grew and central banks were formed, policy errors tended to add to the ups and downs of business. Responding to pressures from their constituents, elected officials would increase Government spending and/or lower taxes. The central bank (in our case, the Federal Reserve) would respond to the resulting increase in economic activity and the demand for funds by creating additional supplies of money and credit. This eventually led to inflation, since demand once more exceeded supplies. In response, fiscal policy would tighten as Washington either raised taxes and/or slashed spending. For its part, the Fed would tighten monetary policy by slowing the growth of the money supply, thus pushing up interest rates. The result, of course, was enough of a softening of business activity to dampen price pressures—in other words, a recession. When the pain of recession became intolerable, policymakers would reverse course—usually overdoing it in the process—resulting in an end to the recession, but the beginnings of the next round of inflation.

### Up And Down

Looking at how the most recent recession developed, and the way in which it ended, the thought occurred to me that if prices of goods and services were to fall when demands weakened the way the price of money (interest rates) does, future recessions might be milder, and the subsequent recoveries a bit stronger. As you might imagine, the very fact that interest rates do decline is the basis for the ability of monetary policy to cushion the blow of a recession. The reduced cost of borrowing makes it worthwhile for some to borrow while permitting others to refinance an existing loan at a lower cost. Both eventually lead to increased spending.

In this past recession, prices of many items did fall, witness the year-over-year declines in the Labor Department's producer price index since the fourth quarter of last year. In particular, prices of commercial and industrial real estate fell, with the resulting decline in rents encouraging many to rent new or additional space. This was also reflected in lower prices for homes, leading to a significant jump in sales of both new and existing homes, and a consequent jump in new-home construction.

Needless to say, these developments have laid the foundation for faster economic growth. Increased residential construction activity obviously boosts the demand for real estate, labor and building materials. More homes purchased and/or commercial space rented leads to a greater need for such items as furniture, home appliances, fixtures and floor coverings, to name a few. As these items are bought and sales rise, the demand ripples back to the manufacturers of these goods, who, naturally will produce more, increasing their own demands for labor, materials, etc.

In the past, prices tended to be sticky—and most still are. Business obviously does not want to cut prices unless its costs fall. Labor rarely makes wage concessions unless the demand for workers falls significantly. And such other business costs as taxes seem to go only in one direction, and that's up. However, if prices don't respond to changed economic conditions, you wind up with a situation such as that faced by the automobile industry. For years, carmakers have raised their prices faster than the incomes of their prospective buyers. Twenty years ago, the average new car cost less than 17 weeks of the average family's income. Today, it's more like 25 weeks. Not surprisingly sales of all new cars have failed to keep up with population growth.

One way to make prices more flexible might be to change the way labor is compensated. Business might pay a base salary, then add a bonus if sales are strong. When sales soften, that bonus might shrink or even disappear. This would not only lower labor costs—usually two-thirds of the typical firm's costs—it might also keep more people employed, since companies wouldn't have to cut payrolls in order to reduce their wage bills. This, too, would help moderate recessions, since aggregate worker purchasing power would not drop as much as it would were unemployment to rise. And, of course, confidence would hold up as well.

### Fiscal Scare

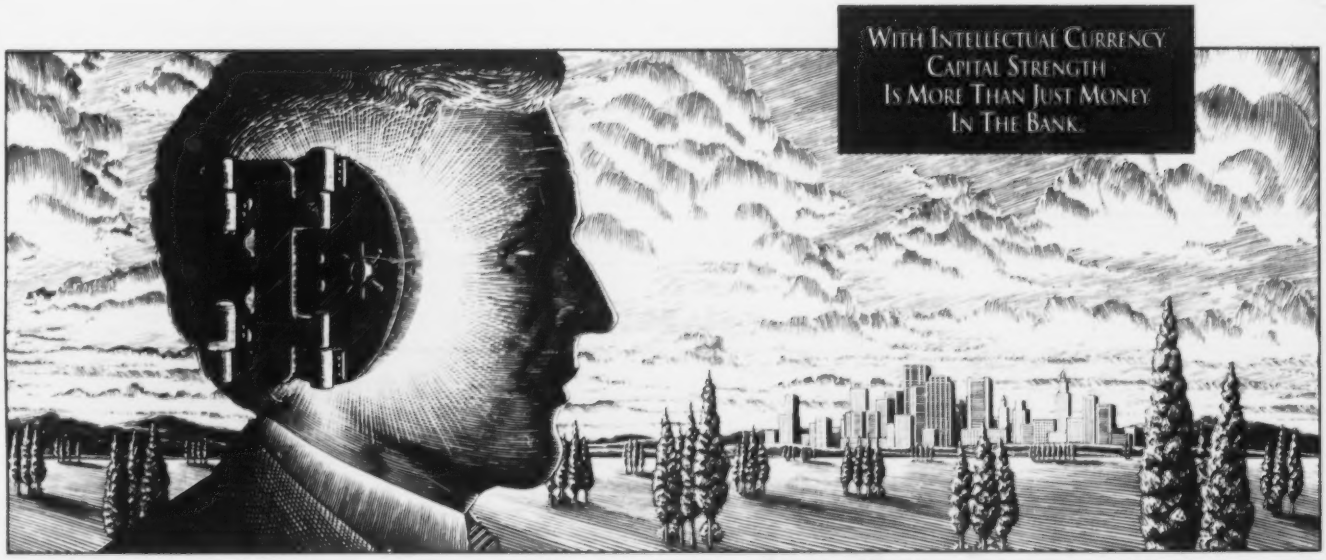
Getting back to one of the points I made earlier, one of the reasons why people are so depressed these days is a belief that the economy needs help, and that Washington is powerless to do very much about it. To be sure, politicians from both major parties have proposed legislation to help move economic activity into higher gear. However, with the Government's budget deficit headed toward $400 billion this year, few think much can be expected from fiscal policy. Indeed, more than a few economists are recommending that whatever legislation does emerge be deficit-neutral. In other words, what Washington might give with one hand, it should take with the other. Some stimulus!

The huge deficit is not only rendering fiscal policy impotent, it is also keeping interest rates on medium- and long-term instruments high. And the accumulation of all the deficits of years past is preventing the Treasury from utilizing flexible debt management techniques. This year, by its own reckoning, the Government will have to borrow over $630 billion—a sum so staggering it is equal to more than twice the savings that the U.S. economy is expected to generate this year. By contrast, in 1960, a budget surplus year, the Government borrowed only $5 billion, representing less than 14 percent of that year's savings. As you might imagine, interest rates were much lower then than they are today.

Most of these funds will have to be raised in the medium- and long-term debt markets, where, unfortunately, rates are the highest. However, as noted in the February issue of this Report, the Treasury has little choice, given how much debt has to be financed. Needless to say, these cash needs, combined with the needs of such other countries as Germany, and the reduced inflow of funds from Japan, spell even higher long-term rates, thus a threat to housing, and, eventually, to the rest of the economy.

Right now, there isn't too much that can be done to reduce the deficit. However, once business picks up, we will have another opportunity to reduce the deficit once and for all, so that the next time the economy goes into a recession (and there will be a next time; remember the reference above to human nature and policy errors), fiscal policy can join monetary policy to soften the blow.

Of course, elected officials only respond to what they believe the voters want. So it is up to us, the American people, to learn an important lesson from this latest episode. Just like someone who's had a heart attack and survives takes the warning seriously by going on a diet, exercising, and changing his lifestyle, so we must consider this deficit scare as a warning, too. We need to put ourselves on a fiscal diet by demanding from Government only what we are willing to pay for in the form of taxes. It won't happen overnight—nor should it; it's a long-term, not particularly appealing process. However, it may be our last chance. ■

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# Economic Report

June 1992

Commentary on Pertinent Economic Issues

## Back To Basics

**Irwin L. Kellner**
**Chief Economist**

When last we left the United States economy, it was in the recovery room. America's ninth postwar recession, which began in August 1990, apparently ended in spring 1991. Since then, business activity has been expanding—although at a painfully slow pace. Indeed, so slow has the turnaround been that, depending on the type and location of one's business, more than a few people find it difficult to believe that the recession is still not with us.

This is affecting attitudes, and, in turn, the economy as well. For one thing, employment levels today are further away from where they were when the economy peaked than they usually are at this point in the cycle. Obviously, this implies a tougher time finding work for those who are jobless. In turn, this is keeping people (both employed and unemployed) from spending as much as they might have at this point in the past, more than one year after the economy stopped declining.

You can see where this is affecting business strategies. The ongoing sluggishness in consumer spending, combined with the generally cautious attitude on the part of many executives, is causing many firms to try to operate with only the barest minimum of inventories. This policy apparently gives many business people a feeling of security, in that if sales should suddenly collapse, they will not be stuck with large amounts of unsold goods. Naturally, this also represents a way to save money, since goods produced must be paid for even before they are sold. The money to pay for goods that wind up on shelves is usually borrowed, so the less unsold goods, the less money must be borrowed—and the less interest expense business incurs. Not surprisingly, most bankers, who judge business activity by the demand for loans, will tell you that business remains soft.

There is no doubt in my mind that we have entered a new era—one of lowered expectations. You can deduce this from business hiring practices—which continue to be modest, at best. Many firms are apparently still smarting over the bulking up they did in the 1980s, when they added layers of management and support staff in the belief that the markets they were in would grow indefinitely—not to mention the fact that it was the trend du jour. Today's in thing among senior corporate managers is to be as lean and mean as possible and assume that markets will continue their present trend of growing only slowly—if at all. Like many trends, this, too, will not endure. However, while it prevails, it only serves to darken the mood of both businessmen and consumers, and, of course, to perpetuate today's slow-growth economy.

If the past is any guide, don't look for any sea change in people's attitudes anytime soon. In the last Economic Report, I discussed the role that human nature plays in the business cycle. People tend to try to take advantage by raising prices and/or wages, when demand for a product or service overwhelms supply; they'll do this until they've priced themselves out of the market. It usually takes a while before people realize that they've gone too far—and that goes, not only for pricing, but for other notions, such as caution when it comes to hiring, inventory accumulation, buying new machinery, etc.

### Ten-Year Economic Waves

These trends last so long, they tend to be identified with entire decades. You all have heard of the Roaring Twenties. This was the decade that followed World War I, and the end of wartime restrictions on business and consumers (the Sober Decade). It brought sweeping changes to American life, as the U.S. economy entered a period of spectacular, though uneven, economic growth. Spurred by good times and a desire to be "modern," Americans adopted new attitudes and lifestyles; people moved from farms to cities in record numbers. The demand for such features of modern life as the automobile, telephone, radio and electric washing machines soared.

These good times extended to Wall Street—until the stock market crash of 1929. This sent shock waves through the financial community. Banks severely curtailed their loans to business, which, in turn, cut back production, leading to the Great Depression of the 1930s. The aftermath of the overexuberant 1920s, the 1930s saw thousands of businesses fold and millions of workers lose their jobs. Overleveraging and

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Economic Report

poor weather forced large numbers of farmers to abandon their farms; they moved to the cities to join the vast army of unemployed urban dwellers. In an effort to shore up domestic business, Congress passed, and President Hoover signed into law, the Smoot-Hawley Act, restricting imports. Other countries retaliated, which hurt U.S. exports, deepening our downturn.

Notwithstanding the efforts of President Roosevelt and his New Deal economic program, hard times dragged on until the advent of World War II, and the stimulus of a huge jump in military spending. The Forties were years of substantial growth. Auto plants and other factories had to be converted into defense mills for the production of planes, ships, tanks, and other weapons of war. Unemployment disappeared rapidly as men first found work in these factories, then were called up to serve in the military. Restrictions on civilian spending were imposed to free resources for the war effort. This led to pent-up demand, which, literally, exploded once the war ended. Returning veterans and their families bought products not previously available, such as new cars, refrigerators, etc.

Bolstered by labor unions, workers' buying power rose to the point where many were able to afford to buy a house, so the move to the suburbs began. Naturally, this led to a surge in construction of homes, schools, shopping centers and roads, fueling a rapid increase in jobs, hence, more growth in buying power. Unfortunately, prices jumped rapidly as well, setting the stage for the consolidation of the 1950s. Known as the Silent Generation, Americans, following the end of the Korean War, turned inward and concentrated on social reforms. The move to the suburbs slowed, and many localities began to impose restrictions on new building, leading to a slowdown in construction. A conservative economic policy cooled inflation—but at the cost of several recessions.

### Every Other Decade Booms

The 1960s quickly became known as the Soaring Sixties. Pushed ahead by stimulative economic policies and by the progressive growth in military spending associated with the war in Vietnam, the U.S. economy registered its longest expansion in history—a record 106 months—between February 1961 and December 1969. Economic growth soared and the unemployment rate fell to a postwar low of just over three percent. However, the Johnson Administration's fiscal policy, which called for no increase in taxes to finance both increased military spending as well as greater outlays for domestic purposes (Guns and Butter), along with an accommodating monetary policy, laid the groundwork for the inflationary 1970s.

Dubbed by some, the Hangover Decade, the 1970s were marked by rapidly rising prices as an aftermath of the stimulative policies of the 1960s, unusually bad weather affecting the Nation's crops, a deal with the Soviet Union which tied up the country's boxcars, two freezes and four phases of price controls—and, of course, a massive jump in oil prices twice engineered by the Organization of Petroleum Exporting Countries. If these developments weren't enough to depress people, attitudes were severely battered by political scandals; both the President of the United States and the Vice President resigned within a ten-month period.

The spurt in energy prices reversed several trends of the postwar era which fueled economic growth. It caused people to turn away from the suburbs and back toward the cities, which were more energy-efficient. It also encouraged people to stop buying American cars, which were large and got poor gas mileage, and turn, instead, to foreign cars, which tended to be smaller and much more fuel efficient. And it also caused many companies to substitute labor for equipment. This was an attempt to offset the rise in energy costs—but it led to the overstaffing and poor productivity that was to characterize the 1980s.

The 1980s started out in reverse. The economy was in recession for most of the decade's first three years before responding to the stimulus provided by the Reagan Administration's Economic Recovery Tax Act of 1980 (ERTA). This is because the initial result of this program was a sharp jump in interest rates as Washington's budget deficit soared, forcing a dramatic rise in the Government's borrowing needs while the new tax law spurred borrowing by both consumers and businessmen. These high and rising interest rates attracted money from abroad, thus boosting the value of the dollar in the foreign exchange markets. By early 1985, the dollar had become so strong, it depressed our domestic manufacturing industries; U.S. exports became so costly overseas as to be uncompetitive, while foreign-made goods, by contrast, flowed into this country at a record rate because they became extremely inexpensive.

**CHEMICAL BANKING**
**Forecast of Gross Domestic Product**
**(Seasonally Adjusted Annual Rates)**
**In $ Billions**

| | < Actual | Projected > | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1992 | | | | YEAR 1992 | | 1993 | | | | YEAR 1993 | |
| | 1 | 2 | 3 | 4 | LEVEL | % CH | 1 | 2 | 3 | 4 | LEVEL | % CH |
| Gross Domestic Product | 5817.5 | 5877.6 | 5956.2 | 6043.5 | 5923.7 | 4.4 | 6133.9 | 6219.5 | 6312.0 | 6389.4 | 6263.7 | 5.7 |
| GDP: $87 | 4896.9 | 4924.7 | 4959.4 | 4994.6 | 4943.9 | 2.0 | 5032.5 | 5063.8 | 5090.1 | 5103.0 | 5072.3 | 2.6 |
| % Change, Annual Rates | 2.4 | 2.3 | 2.8 | 2.9 | 2.0 | | 3.1 | 2.5 | 2.1 | 1.0 | 2.6 | |
| Consumption $87 | 3314.2 | 3328.9 | 3354.1 | 3380.8 | 3344.5 | 2.6 | 3408.2 | 3428.6 | 3444.2 | 3458.9 | 3435.0 | 2.7 |
| Durables $87 | 430.0 | 425.0 | 429.6 | 435.4 | 430.0 | 4.2 | 445.5 | 449.4 | 450.3 | 455.0 | 450.0 | 4.7 |
| Non-Durables $87 | 1049.6 | 1058.2 | 1064.5 | 1075.1 | 1061.9 | 1.8 | 1079.8 | 1089.7 | 1084.2 | 1099.5 | 1088.3 | 2.5 |
| Services $87 | 1834.5 | 1845.7 | 1860.0 | 1870.2 | 1852.6 | 2.7 | 1882.9 | 1889.5 | 1909.7 | 1904.4 | 1896.6 | 2.4 |
| Investment $87 | 674.7 | 695.8 | 700.0 | 709.1 | 694.7 | 3.1 | 726.4 | 716.2 | 736.8 | 734.5 | 728.5 | 4.9 |
| Non-Residential $87 | 507.7 | 497.8 | 505.0 | 510.4 | 505.2 | -1.4 | 520.8 | 524.0 | 528.9 | 549.4 | 530.8 | 5.1 |
| Producers Durable Equip. $87 | 363.4 | 362.9 | 369.5 | 375.3 | 367.8 | 2.6 | 380.7 | 378.6 | 384.1 | 399.9 | 385.8 | 4.9 |
| Structures $87 | 144.3 | 134.9 | 135.5 | 135.1 | 137.5 | -10.7 | 140.2 | 145.3 | 144.9 | 149.5 | 145.0 | 5.5 |
| Residential $87 | 185.4 | 184.6 | 189.5 | 195.6 | 188.8 | 7.7 | 213.4 | 205.7 | 194.6 | 179.9 | 198.4 | 5.1 |
| Inventory Changes $87 | -18.4 | 12.7 | 5.4 | 3.1 | 0.7 | | -7.8 | -13.5 | 13.3 | 5.3 | -0.7 | |
| Net Exports $87 | -22.3 | -34.6 | -40.0 | -45.5 | -35.6 | | -44.7 | -29.7 | -25.6 | -31.1 | -32.8 | |
| Exports $87 | 556.7 | 540.3 | 534.8 | 530.0 | 540.5 | 0.5 | 535.1 | 545.4 | 544.8 | 544.7 | 542.5 | 0.4 |
| Imports $87 | 579.0 | 574.9 | 574.8 | 575.5 | 576.0 | 3.1 | 579.8 | 575.1 | 570.4 | 575.8 | 575.3 | -0.1 |
| Government Purchases $87 | 930.4 | 935.3 | 945.2 | 950.2 | 940.3 | 0.3 | 942.5 | 948.7 | 934.7 | 940.6 | 941.6 | 0.1 |
| Federal Defense $87 | 267.1 | 264.8 | 259.7 | 254.9 | 261.6 | -7.0 | 247.7 | 243.6 | 239.4 | 234.9 | 241.4 | -7.7 |
| Federal Civilian $87 | 105.2 | 110.5 | 115.5 | 120.0 | 112.8 | 9.0 | 119.9 | 124.9 | 120.3 | 125.6 | 122.7 | 8.7 |
| State & Local $87 | 558.0 | 560.0 | 570.0 | 575.3 | 565.8 | 2.5 | 575.0 | 580.2 | 575.0 | 580.1 | 577.6 | 2.1 |
| Final Sales: $87 | 4915.3 | 4912.0 | 4953.9 | 4991.5 | 4943.2 | 1.7 | 5040.3 | 5077.3 | 5076.8 | 5097.7 | 5073.0 | 2.6 |
| % Change, Annual Rates | 4.6 | -0.3 | 3.5 | 3.1 | 1.7 | | 4.0 | 3.0 | 0.0 | 1.7 | 2.6 | |
| Domestic Demand: $87 | 4919.2 | 4959.3 | 4999.4 | 5040.1 | 4979.5 | 2.3 | 5077.1 | 5093.5 | 5115.7 | 5134.1 | 5105.1 | 2.5 |
| % Change, Annual Rates | 2.5 | 3.3 | 3.3 | 3.3 | 2.3 | | 3.0 | 1.3 | 1.8 | 1.4 | 2.5 | |
| GDP Price Index (1987 = 100) | 118.8 | 119.3 | 120.1 | 121.0 | 119.8 | 2.4 | 121.9 | 122.8 | 124.0 | 125.2 | 123.5 | 3.1 |
| % Change, Annual Rates | 3.1 | 1.9 | 2.5 | 3.0 | 2.4 | | 3.0 | 3.1 | 3.9 | 3.9 | 3.1 | |
| Consumer Price Index (82-84 = 100) | 138.8 | 139.7 | 140.7 | 141.8 | 140.2 | 2.9 | 143.0 | 143.9 | 145.1 | 146.4 | 144.6 | 3.1 |
| % Change, Annual Rates | 3.1 | 2.6 | 2.8 | 3.2 | 2.9 | | 3.4 | 2.8 | 3.1 | 3.6 | 3.1 | |
| Total Personal Income | 4956.2 | 4972.1 | 5033.7 | 5106.5 | 5017.1 | 3.8 | 5200.0 | 5271.9 | 5333.4 | 5396.4 | 5300.4 | 5.6 |
| Disposable Personal Income | 4345.1 | 4375.2 | 4427.5 | 4471.7 | 4404.9 | 4.4 | 4545.2 | 4607.0 | 4660.0 | 4714.4 | 4631.6 | 5.1 |
| Savings Rate | 4.9 | 5.0 | 4.7 | 4.0 | 4.6 | | 3.9 | 3.9 | 3.7 | 3.6 | 3.8 | |
| Unemployment Rate | 7.2 | 7.2 | 7.0 | 6.8 | 7.1 | | 6.8 | 6.7 | 6.8 | 7.0 | 6.8 | |
| Indus. Production (1987 = 100) | 107.1 | 108.8 | 108.9 | 110.1 | 108.7 | 1.5 | 110.8 | 110.6 | 110.3 | 109.7 | 110.3 | 1.5 |
| Housing Starts (000) | 1260.3 | 1316.2 | 1404.5 | 1361.7 | 1335.7 | 31.9 | 1352.3 | 1315.9 | 1298.0 | 1140.3 | 1276.6 | -4.4 |
| Domestic Auto Sales (000) | 6031.0 | 6253.5 | 6498.3 | 6435.3 | 6304.5 | 2.5 | 6777.9 | 6564.7 | 6393.6 | 6146.4 | 6470.7 | 2.6 |
| Corporate Pre-Tax Profits | 339.8 | 397.0 | 447.0 | 483.0 | 416.7 | 33.4 | 506.0 | 498.0 | 470.0 | 450.0 | 481.0 | 15.4 |
| Net Profits | 204.9 | 238.2 | 268.2 | 289.8 | 250.3 | 33.2 | 303.6 | 298.8 | 282.0 | 270.0 | 288.6 | 15.3 |

Source: Economics Department: June 1992

The combination of the efforts by the country's goods producers to adapt to this new era of international competition, as well as the tax laws resulting from ERTA, led to a massive restructuring of American industry—first the goods-producing sector in mid-decade, later on, the service side. The architects of this restructuring, people skilled in both finance and the tax laws, were in great demand, and, along with those who developed complex financial instruments, invested and speculated, became extremely wealthy in the process. This led some to characterize the 1980s as the Decade of Greed.

Like the 1960s, the decade of the 1980s was one of prolonged growth; it contained the second-longest (92 months) expansion in U.S. economic history. However, to some it didn't feel all that good. Many blue-collar workers lost their jobs when the country's factories restructured to meet foreign competition in mid-decade; their white-collar counterparts found themselves in the same boat as the decade's mergers, corporate takeovers, and leveraged buyouts led to sizable reductions in staff positions. The passage of the Tax Reform Act of 1986, by retroactively changing the rules for investing especially in real estate, set the stage for the collapse of the stock market in 1987, and the subsequent trimming back by Wall Street. At the same time, the major banks began to set aside reserves to cover their developing country debt; this necessitated cutbacks to replenish lost earnings.

Another byproduct of the Tax Act of 1986 was the demise of many thrifts, mainly savings and loans. This caused the regulators of commercial banks to require that they increase their capital in order to "protect" taxpayers from another S&L-type bailout. It was accompanied by admonitions not to make certain types of loans, such as to real estate developers, and for leveraged buyouts. The result—more layoffs of people working in real estate-related jobs, financial services, accounting and the law. With all of these above-average income people losing jobs that in the past appeared to be insulated from the ravages of the business cycle—not to mention the sharp drop in real estate values—it's not hard to understand why we're now in another era of consolidation, which, if the past is any guide, could last for most of this decade.

### The Moderate Nineties

This explains why attitudes are so cautious—but even more important, it may well offer some important insights into the years ahead. Far more important than the percentage by which the gross domestic product expands this quarter or even this year is what the socio-economic climate will bring. In my opinion, this will have a much greater impact on Corporate America's ability to make a buck, on people's chances of finding jobs, and, as a society, on our overall sense of well being.

Apparently it takes about ten years for people's memories of the previous decade's opportunities and mistakes to fade. The implications for the business outlook go far beyond the numbers presented in the table to the left. Growth in the years ahead is likely to be slow—but so will inflation. This means no sharp swings—up or down—are likely. Less risk, maybe—but also less of an opportunity for reward.

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# Economic Report

August 1992

Commentary on Pertinent Economic Issues

## A Two-Edged Sword

**Irwin L. Kellner**
**Chief Economist**

There is an old expression which goes something like this: "Be careful what you wish for—your wish may come true!" For years, a number of people and policymakers have been wishing for less inflation—if not its elimination altogether. These hopes became especially fervent after our bouts with double-digit inflation in the mid-1970s, and again, towards the end of that decade and the first couple of years of the 1980s. Indeed, the slowing and virtual elimination of inflation has been the hallmark of the Federal Reserve's monetary policy for many years.

Well, guess what? Inflation has slowed considerably from its overheated pace of ten years ago. As a matter of fact, in many sectors of the U.S. economy, inflation has not only disappeared—it has been replaced by deflation, in other words, falling prices. Now some people are beginning to wonder if less inflation is all it's cracked up to be. This is because the curbing of inflation has apparently produced a number of side-effects—not the least of which may be the difficulty that the economy is having in escaping from the clutches of recession.

Because most people have known nothing but noticeable inflation since becoming economic adults, they have made decisions in the belief that inflation would continue. Some came to this conclusion involuntarily, figuring that there was no use in fighting higher prices. Others, seeing their incomes rise with inflation, were more willing to accept it. Whatever the case, the slowing of inflation that has already occurred—not to mention what may lie ahead if Fed Chairman Alan Greenspan gets his way—calls for a re-examination of many people's beliefs, buying habits, investment and business decisions.

Both key price indexes—measuring year-over-year percentage changes in prices at the consumer and the producer, or the wholesale, levels—are posting a much slower rate of inflation today than as recently as the end of 1990, not to mention ten years ago. Without subtracting any of the so-called "volatile" components, mainly food and energy, consumer prices today are rising at a yearly rate of about three percent, while producer prices are expanding at little more than half that pace. By contrast, both measures rose at a double-digit yearly clip during the years 1979 through 1981 inclusive.

Those who have been forced to accept inflation undoubtedly have no problem with its slowing. As a matter of fact, since no one likes to pay more for anything, those who look only at this aspect of inflation are not disappointed by its curbing. However, there's more to inflation than simply what the buyer sees, and it is these other sides of inflation that warrant examination at this time.

### The Other Side Of Less Inflation

Let's start with one of the more publicized reasons for today's sluggish economy—the need for consumers and business to reduce some of the debts they have taken on over the years. As you know, many companies are trying to cut expenses in order to generate the cash flow to service the debts they assumed in the 1980s, when leveraging became the strategy du jour. This has become imperative for two reasons: (1) Less inflation in general makes it difficult for individual companies to raise selling prices and reduce the burden of existing debt; (2) "Real", or inflation-adjusted long-term interest rates remain unusually high, making existing debt even more burdensome.

Cutting expenses, means, of course, cutting costs. Business costs are usually divided into those that are fixed and those that are variable. The most prominent variable cost—if not the largest—for any firm is the cost of labor. Not surprisingly, many companies have reduced their payrolls by substantial amounts—not just blue-collar employees, but white-collar staffers as well. These layoffs, well publicized as they have been, have caused great concern for many people—not just those who have lost their jobs, but the great majority who are still employed but who worry that they might be next—with the result that spending has been dampened. In turn, this had led to disappointing sales, causing yet additional layoffs—a vicious cycle.

Another reason why people aren't spending traces to the paucity of wage increases. With the reported rate of unemployment at midyear at an eight-year high, most people are in no position to ask for a raise. Indeed, many find that

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the period between salary hikes has been stretched out well beyond a year, effectively freezing their pay—and reducing their buying power, once even today's low rate of inflation (along with higher taxes) is taken into account. These folks will buy only what they feel they must, from the cheapest nearby outlet; they certainly oppose paying more—which, of course, impacts the sales dollars business rings up at the cash register.

And it's not just the fact that people's incomes aren't growing that's keeping them from spending. It's also that the value of most families' biggest asset—their home—is actually falling. This has not only left many households with less of a financial cushion than they might have planned on, it also has affected their attitudes, which, of course, has translated into reduced spending. Needless to say, there are more than a few families who find themselves today owing more on their house than it is worth; these folks wouldn't mind seeing inflation make a comeback.

### Many People Like Inflation

Borrowers in general like inflation for several reasons. First, their loans are paid off with cheaper dollars—the longer the term of the loan, the cheaper the dollars as long as inflation continues to erode the buying power of the buck. Second, since borrowing permits one to buy something sooner than would otherwise be the case had one waited until enough money was saved to afford the purchase, a borrower is ahead in a period of inflation since buying sooner rather than later beats higher prices. Because of this, many people have not hesitated to go into debt, expecting to be bailed out by inflation; these people are the ones most squeezed by today's low-inflation environment.

Lenders also have a stake in inflation. For one thing, when it is relatively easy for companies to hike selling prices, it is also easier for them to service their debts, thus helping many a bank lending officer sleep better at night. (Of course, if these loan officers were to consider the reduced buying power of the dollars they were getting back, they might have a nightmare or two.) In addition, since most loans are made on a floating rate basis, when more inflation causes interest rates in general to rise, the rates on the banks' existing loans will rise as well.

To be sure, inflation also raises the banks' non-interest operating costs, such as salaries, office supplies and maintenance. This requires that they lend increased numbers of dollars, if they are to spread these rising costs over a larger volume. No problem, since higher rates of inflation tend to increase the demand for loans by business to finance inventories and receivables, buy new equipment, etc. Indeed, another reason for today's sluggish economy is that companies are trying to keep their inventory levels down, and are holding off investing in new machinery and equipment—not only to cut costs, but because they don't expect prices of these items to rise in the near term. Their strategies would be the exact opposite if they thought prices of these items were about to rise.

If borrowers and lenders have learned to live with inflation, what about savers? No problem, here as well, since savers have come to like inflation, too. This may strike the reader as odd, since inflation clearly erodes the buying power of existing savings. However, as any saver will attest today, the low rate of inflation has also led to low interest rates. And with interest income twice as important to personal incomes today as it was 30 years ago, many people are finding that their actual buying power is worse off because inflation is low, rather than high.

Senior citizens, in particular, are hurting. As you know, they rely almost exclusively on interest from their savings to live on. With interest rates in many cases at 30-year lows, their interest income has suffered accordingly. In addition, their Social Security benefits have been growing by progressively smaller annual increments as the rate of inflation has come down. Meanwhile, their expenses—especially health care—continue to mount.

Besides Social Security recipients, many other people's incomes are linked, or indexed, to inflation. These include retired government workers, those receiving food stamps and disability payments, and those who are on the receiving end of Washington's many entitlement programs. Indeed, according to recent estimates, about one-third of all government outlays goes to programs whose benefits are indexed to the rate of inflation. Clearly, since they keep up with it, these people are at the very least indifferent to inflation.

Of course, indexing is widespread in the private sector as well. Indeed, it was a labor union in the private sector, the United Auto Workers, which in 1948 negotiated the first labor contract that included a cost-of-living adjustment (COLA). These COLA clauses were slow to catch on, but by 1965 more than a quarter of all

unionized employees were covered by such agreements; the percentage climbed to nearly 60 percent by the mid-1980s, before falling back to 29 percent today.

Non-union workers used to keep up with inflation, too. Either because of the COLAs union workers would receive, or because of the general awareness of inflation, those who didn't get automatic adjustments in their pay tended to receive raises linked to inflation informally. Many white-collar workers got used to receiving a cost-of-living adjustment at least annually; they are now smarting from its absence.

Getting back to the business side, inflation tends to help management in many ways. For one thing, it allows companies to raise their prices without fear of losing customers, since people are more likely to accept higher prices in an inflationary environment than when prices are more stable. Naturally, inflation boosts the dollar value of sales. In addition, many businessmen look to inflation as a cushion, enabling them to pass along increases in costs more readily in an inflationary environment than in an era of price stability. The net result: Inflationary times tend to boost profits, thus the compensation of corporate managers.

Certainly real estate developers must be longing for inflation. As a matter of fact, with this sector's price deflation of the past few years, most folks involved in real estate would probably settle for "flation" (price stability). Landlords have long inserted COLA clauses in their leases, while buying properties with only the smallest of down payments and the longest of mortgages. Inflation has obviously enabled these people to service their debts; deflation clearly has made it more problematic.

### Elected Officials Need Inflation

One group with a major interest in inflation is elected officials. Let's start with the notion that many people equate inflation with prosperity and deflation with bad times—a not unreasonable thought in today's low-inflation, but depressed economy. At the end of the Second World War, the greatest fear was that, without the stimulus of wartime spending, the U.S. economy would lapse back into depression. But as the end of wartime controls permitted companies to raise prices (and labor to obtain wage increases), the electorate began to feel better—even though inflation had flared up. The line of reasoning at the time was that inflation could occur only if the economy were strong enough to permit business to raise prices, and it was the economy's strength that was most important to people. Sound familiar? It must, to those running for elective office this year, since many proposals coming from both the White House and the Congress would wind up boosting inflation (and presumably confidence) as well.

At another level, consider that inflation increases tax revenues for all governments. Incomes tend to be boosted by inflation, which lifts tax revenues from this source; sales and property tax collections will rise for similar reasons. More revenues, of course, mean more money is available to be spent on the politicians' constituents (and even to help balance budgets).

Now that we've examined the other side of inflation, the question is whether people will really want to stay the course, and support a policy of low—indeed, even lower—inflation. It's pretty clear that those who did more than simply accept high inflation—by betting on its continuance—are suffering the most. Real estate developers come to mind, but any individual or company that took on a lot of debt is also being squeezed. This is hurting the economy, as I have already demonstrated. On the other hand, those who did not believe that inflation would slow and failed to lock in the higher interest rates of the early and mid-1980s are unhappy, too. One might even add that the President's chances of being re-elected have also been affected by today's low inflation environment.

### Will The Fed Keep Inflation Down?

Since inflation, in the final analysis, is a monetary phenomenon, the answer to the question about staying the course must ultimately come from the Federal Reserve. On the surface, the Fed appears to be determined to lick inflation—or at least reduce it to the point where it no longer is part of people's decisions to buy, sell or invest. This would be acceptable were it not for our experiences of the past, as described above. In any event, the Fed may be saying one thing, but it is doing another. Bank reserves adjusted for reserve requirements are today growing at their fastest yearly pace in five years, the money supply (excluding certificates of deposit) is soaring, and industrial raw materials prices have shot up nearly nine percent since February. Unless the Fed reverses course, generalized inflation will return—accommodating perhaps even more people's wishes in the process.

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October 1992

Commentary on Pertinent Economic Issues

## Prescription For Prosperity

Irwin L. Kellner
Chief Economist

While President Bush and Governor Clinton vie for the Presidency, the rest of the country is battling to extricate itself from one of the slowest three-year periods of economic growth since the 1930s. Indeed, growth is so slow as to be nonexistent in a number of industries in some regions of the United States. What is more, instead of creating jobs, the recovery is so weak that it is causing many companies to shed workers, thereby exacerbating the economic malaise.

On top of all this, there is a feeling outside the nation's capital that the people chosen to run this country find themselves unable to do anything to jump-start the economy. This, too, is a six-decade first: not since the 1930s has Washington been so powerless. Then, the government was too small to exert much influence over the course of economic events, even if it knew what to do—and it didn't, since taxes were raised and the money supply shrunk, when just the opposite was called for. Today, of course, the government is big enough to influence economic activity (some would say too big, but that's another story), and policymakers presumably know what to do.

### Policy Levers Inoperative

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The problem is that the three levers that Washington uses to guide the economy have been used to their maximum, and are no longer operative. The government influences economic activity through monetary and fiscal policies and through changing the value of the dollar in foreign exchange markets. Let's examine each to see why Washington appears to be powerless.

Monetary policy has eased considerably since the beginning of 1989, when the Federal funds rate was 10 percent, and bank reserves were hardly growing. Today, short-term interest rates are at 30-year lows, yet consumers and business continue to pay off debt. This is because both lack confidence: people are afraid of losing their jobs, while most businessmen see only dim prospects for sales. In this environment, the Fed could push interest rates down to zero without boosting borrowing.

This could be the 1990s version of the 1930s "liquidity trap," a theory advanced by the great economist, John Maynard Keynes, who pointed out that monetary policy by itself cannot revive a weakened economy. Indeed, if anything, today's low interest rates may have produced the opposite of what the Fed intended by discouraging spending. This is because a lot of people rely on interest income: it's over 13 percent of personal incomes today, compared with only six percent back in 1960. Plainly, the sharp drop in interest rates on bank certificates of deposit, Treasury bills, etc., has cut deeply into this important source of buying power.

Another reason why the monetary lever can't be used any more stems from what the Fed has had to do in order to get rates this low. Bank reserves this year are growing at the fastest pace since 1987—11 percent annually. This has sent the basic money supply M1, as well as a broader measure, M2 minus small CDs, soaring at more than a 10 percent annual clip so far this year, leading a number of economists to express concern that, if anything, monetary policy may be too easy.

Fiscal policy is seemingly impotent as well. Washington's budget deficit is so huge, the government can't deliberately widen it by cutting taxes and/or increasing spending—two remedies that were recommended by Keynes to boost economic activity back in the 1930s, and which have been used throughout the postwar period, whenever stimulus was called for. The deficit for the government's fiscal year that ended September 30 very likely reached $340 billion. This is the biggest ever in absolute terms, and is one of the largest relative to the size of the U.S. economy since just after World War II. As a consequence, Washington's debt outstanding now amounts to $4.1 trillion—an amount that equals 70 percent of the gross national product, the most in 36 years.

Since most short-term rates are almost as low today as they were in 1960, it is pretty clear that the bond markets—where rates haven't fallen nearly as much—are deeply concerned about the size of the government's deficit, and who will buy all the paper the Treasury will have to issue. Thus any attempt to deliberately widen the deficit would probably result in a sharp runup in long-term interest rates, since it would mean even more Treasury paper coming to market.

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The government's inability to use its fiscal and monetary levers limits its freedom to alter the value of the dollar in foreign exchange markets. To depress the dollar, which would make our exports cheaper overseas while increasing the price of imported merchandise, the Fed would have to create more dollars—in other words, ease money further. But this is not practical for reasons discussed above. At the same time, the already-huge budget deficit necessitates that Washington sell some of its securities abroad, in order to avoid congestion in our domestic markets. But overseas investors will not buy Treasury securities if the dollar is falling and dollar-denominated interest rates are low. A falling dollar reduces the value of foreigners' holdings, while U.S. rates lower than elsewhere mean they could earn more by investing in other countries.

But even if it could, Washington probably wouldn't want to lower the value of the dollar any further in today's circumstances. Even after its recent bounce, the dollar is extremely undervalued against the European currencies. This has contributed to Europe's weakness, since its member countries are finding it harder and harder to sell goods to the U.S. and to other countries whose currencies move with the dollar. Then there is the confidence factor: notwithstanding our troubles, the dollar remains the backbone of the world's financial system, since most transactions are priced in dollars. And let's not forget inflation, which could arise from today's undervalued dollar, much less one whose value is even more depressed. This is another reason why bond rates remain relatively high.

### Leave It To Business?

We could, of course, wait for the private sector to change course, and boost the economy. After all, even with government as big as it is, business and consumers still account for three-quarters of the gross domestic product. Eventually, companies will have to stop laying off people, and begin hiring once again. For their part, consumers at some point will have to buy that new car or house, furniture, home appliance, garment, etc. So why not wait and avoid creating any more problems than we already have by easing money, widening the deficit or cheapening the dollar?

Well, as our experience in the 1930s showed, declines have a way of feeding on themselves, and a change in course by the private sector could be a long time in coming. Meanwhile, there would remain much economic misery, which, if the past is any guide, could lead to social and political upheavals that might affect this country for years to come.

Right now, hiring seems to be the last thing on businessmen's minds. Because sales are so soft many firms are trying to cut costs by cutting their staffs. The need to reduce some of the debts they may have taken on during the 1980s could well be a factor, too. However, what may be good for the individual company has become bad for the economy as a whole, because it has resulted in virtually no growth in nonfarm payroll employment since the economy hit bottom back in the spring of 1991. By contrast, payrolls at this point in past recoveries averaged five percent bigger. Not surprisingly, consumer confidence remains low, and, when combined with people's high debts and lack of growth in buying power, has resulted in today's weak retail sales results. Needless to say, these poor sales tend to produce yet more cutbacks in employment, leading to less spending, and so on.

This vicious cycle could come to an end once debts are reduced to more comfortable levels, payrolls are so thin that normal business can't be conducted, or when prices start to rise fast enough to encourage buying rather than waiting. Regarding debts, consumers may be paying down installment debt, but, in many cases, they are replacing it with home-equity debt, which usually carries a lower interest rate that may still be deductible from their income tax liabilities. Relative to take-home pay, consumer debts in total have dropped only slightly from their recent record high.

Businesses have made more progress—but since their debts had jumped so dramatically during the 1980s, they have an even longer way to go before reaching desired levels. The amount of debt on business' books today remains 50 percent higher relative to net profits than it was two decades ago—and 2½ times as high as it was at the start of the 1980s.

Staffing appears to be closer to desired levels. Productivity gains have enabled many firms to handle increased business without increasing the size of their staffs, but others have had to lengthen the workweek, while still others have begun to hire "contract," or temporary employees. Both of these steps usually lead to increased hiring. As for inflation as a stimulus for growth, both the consumer and producer price indexes continue to reflect very little in the way of price increases—although industrial raw materials' prices have jumped by close to ten per-

cent since February. In any event, the financial markets would react negatively if inflation were to rise, sending interest rates up, and depressing the economy even more.

**My Solution**

I think there is a way to jump-start the economy, and the pluses of doing so far outweigh the negatives of doing something else or nothing at all. In my opinion, we face not just the one problem of a sluggish economy, but a second problem of the burgeoning budget deficit. With this in mind, two courses of action would appear to be necessary: the first, to deal with the more immediate and pressing problem of boosting economic growth, while the second is to address the longer-run issue of reducing the deficit.

Since the economy's problems are so similar to the 1930s, I think the main solution should stem from that era as well. I refer specifically to the government assuming the role of employer of last resort. In the 1930s, this took the form of the Work Projects Administration, or WPA. In the 1990s, it should involve increased public investment in the nation's roads, bridges, water and sewer systems. Our crumbling infrastructure demands repair, the need to lower costs and increase competitiveness makes it good for business, while the availability of people to do the job makes it good for the economy as well.

Such a program would have tremendous ripple effects. First, by putting people back to work, we can simultaneously address the twin problems of lack of confidence and depressed spending. Anytime an unemployed person finds a job, that person will feel better—and will spend every dollar earned and then some, addressing deferred needs. This will start the ball rolling. Then remember that it is the private sector that makes the steel, cement and wire cables that go into rebuilding the infrastructure, not government, and you get an additional lift. This will eventually lead to increased hiring, more confidence, income and spending, and so on. As for the money, it's already in the budget, in the form of the transportation bill signed last year by the President, but not yet widely disbursed to the states for a variety of reasons. Why not cut the red tape and get the money out?

The government could also cut Social Security taxes. This is the biggest tax that the average household pays, and right now it's draining considerable buying power from families who need it most. Social Security has always been pay-as-you-go, so what's the point of creating a surplus to be theoretically available for people who retire 20 years from now, at the expense of holding down economic activity today?

Washington should also repeal the luxury tax. This has turned out to be far more harmful to those who build the expensive cars, private planes and yachts, than it has been to would-be buyers. Help business overcome its lack of confidence by making it cheaper to invest in people, equipment, and even physical plant by cutting the capital gains tax and restoring the investment tax credit. These were the key provisions of the Tax Reform Act of 1986, which also hurt the real estate market, thus affecting many industries, so why not go all the way and repeal it entirely? This Act has contributed to the decline in homebuilding, according to a new study conducted under the auspices of the National Bureau of Economic Research. It has cut into new business formation, thereby stripping the economy of its main source of job growth. And, by eliminating the deductibility of consumer interest expense, probably caused much of the decline in new car sales over the past seven years.

To ensure that these strategies work, credit must flow more smoothly throughout the economy. Care should be taken that the regulatory process is not inadvertently choking off this flow of credit. Longer run, the deficit must be reduced. However, serious progress toward cutting the deficit must await faster economic growth. Like a patient needing an operation, the economy must be strong enough to take the strain of deficit reduction. When it is, the only politically acceptable way to reduce the deficit would be to freeze inflation-adjusted government spending on everything except the interest it must pay on its debt, and combine this with a value-added tax excluding food, housing and medical care, a tax on imported oil, and higher taxes on alcohol and tobacco.

As long as the economy is growing, these measures will reduce and eventually eliminate Washington's deficit over time. The deficit is so big, it's difficult to say how long it will take, but my guess is at least five to seven years, after this program is begun—and I wouldn't recommend starting it until 1994 at the earliest.

Our problems are not unsolvable. They merely require the application of some common sense, sacrifice—and political leadership. Surely in a country as great as ours, we can find these traits within ourselves and our leaders.

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